COMMITTEE ON THE BUDGET
MAJORITY CAUCUS
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MID-YEAR BUDGET STATUS

ANSWERING THE CHALLENGE OF 9-11

15 July 2002

The administration's Office of Management and Budget [OMB] today released its *Mid-Session Review*, a summary of the current budget and economic situation. The Congressional Budget Office [CBO] is expected to present its own update in August. In connection with these reports, the House Budget Committee majority has developed the following summary.

Throughout this year, the Nation has been recovering from the triple shock of an economic recession, a brutal terrorist attack, and an ensuing war against terrorism. While the Senate has failed to produce a budget – and is operating without any spending discipline – the House has passed a budget, deemed it to be in force, is conducting the necessary legislative activities to implement it, and is staying within its limits.

This mid-year review shows the effects of all these factors on the current budget situation, and makes one point clear above all: Spending control is crucial for returning to a balanced budget.

OVERVIEW

- ***Urgent and Necessary Spending to Fight Terrorism, Build Homeland/Economic Security.*** The war against terrorism, and the need to quickly enhance homeland security, imposed previously unexpected demands on spending. These have included last September's $40-billion emergency package; quick approval of the "Rumsfeld Review"; creation of the Transportation Safety Administration; and loan guarantees to the airline industry. The administration also has built into its figures an additional $27.1 billion for fiscal year 2002 for the emergency spending bill now in conference.

- ***The Economic Shocks and Their Revenue Effects.*** The recession and the terrorist attacks caused lower-than-expected revenues this year, accounting for about $91 billion in lost revenue since February this year. But this year's stimulus bill was smaller than the administration anticipated, so the deficit increased by only $59 billion since February – to $165 billion. The deficit is projected to decline to $109 billion in 2003.

Authorized by . . . . Jim Nussle, Budget Committee Chairman

- ***Signs of Economic Recovery – Helped by the Tax Cuts.*** Last year's tax cuts were a perfectly timed cushion against the recession and the economic shock of the terrorist attacks. Helped by the tax cuts, the economy rebounded at a 6.1-percent annual rate in the first quarter, and now has settled into a moderate growth rate, expected to continue for the balance of this year and next year. Weak spots remain – including higher-than-desirable unemployment – but nevertheless the signs of recovery are reassuring.

- ***Spending Control is Crucial.*** Increased spending demands, along with the economic factors cited above, account for 86 percent of the growth in this year's deficit. But the budget can be balanced after 2005, if Congress and the President keep future spending under control, according to OMB. Congress cannot control the economy's recovery, but it can control spending.

These points are detailed in the following pages.

WHAT THE MID-SESSION REVIEW MEANS

- The *Mid-Session Review* is an annual report by the administration's Office of Management and Budget [OMB] – required under section 1106, Title 31 of the U.S. Code – providing a mid-year assessment of estimated and projected spending and receipts; new Government obligations since initial submission of the President's budget; and "additional information the President decides is advisable to present to Congress . . ."

- The Congressional Budget Office [CBO] also submits a midyear update of budget and economic projections, usually in August. (This year's CBO's update is expected in late August.) It is important to understand that the two reports do not reflect the same underlying assumptions.

  - OMB and CBO usually reflect normal technical differences in calculating a $2-trillion budget in a $10-trillion economy.

  - In addition, however, OMB's *Mid-Session Review* updates the administration's budget submission and *assumes the policies in the President's budget are enacted*. CBO, on the other hand, makes no policy assumptions in its update. Rather, CBO assumes that current law is continued without any changes. CBO also assumes that appropriations, once enacted, remain in the base even if they were intended as one-time events. For example, the emergency funding amounts provided for rebuilding New York are kept in the CBO baseline permanently, even after the rebuilding of New York is complete. This causes another key difference between CBO and OMB in projecting future spending.

- Given those assumptions, both sets of figures can help clarify the likely outcome for the current fiscal year. *But it should be kept in mind that both are still only projections.*

URGENT AND NECESSARY SPENDING
TO FIGHT TERRORISM, BUILD HOMELAND/ECONOMIC SECURITY

- The terrorist attacks of last September have led to extensive new spending demands that could not have been anticipated. These have included the following:

  - A sum of $40 billion was approved last fall, just after the terrorist attacks, to support the war effort and to help rebuild New York City, among other things.

  - The rapid completion of the "Rumsfeld Review," which called for an additional $17.3 billion in defense spending – principally for the war against terrorism.

  - Creation of the Transportation Safety Administration, and related airport security measures, for which the President requested $4.8 billion.

  - Loan guarantees for the airline business, which faced major challenges after the September 11 attacks.

  - The administration also assumes another $27.1 billion in 2002, the amount of the House version of the emergency supplemental appropriation now in conference.

- Due to the still-unfolding nature of these spending demands, it is difficult to calculate a meaningful total figure for the amount that already has been spent. But one point is clear: *These substantial demands on spending, which had to be met, make it more imperative to control other spending if Congress is to return to balanced budgets.*

THE ECONOMIC SHOCKS
AND THEIR REVENUE EFFECTS

Changes Due to 9-11

- In August last year, both the Office of Management and Budget [OMB] and the Congressional Budget Office [CBO] projected sizeable budget surpluses for fiscal years 2002 and 2003, and for the balance of the decade. *In both cases, these estimates included the revenue effect of the bipartisan tax reduction agreement, which had been implemented in July* (see table on the next page).

  - OMB projected surpluses of $173 billion for fiscal year 2002, $195 billion for fiscal year 2003, and $3.1 trillion for 2002 through 2011 (assuming enactment of the administration's proposed policies at the time).

  - CBO estimated surpluses of $176 billion in 2002, $172 billion in 2003, and $3.4 trillion for 2002 through 2011 (assuming the continuation of what was current law at the time).

Change in Budget Outlook Since August 2001
($Billions, Fiscal Years)

	2001	2002	2003	2004	2005	2006	2007	2002-11
Surplus(+)/Deficit(-)								
CBO August 2001	153	176	172	201	244	289	340	3,397
OMB August 2001	158	173	195	217	254	281	314	3,113
OMB July 2002	127	-165	-109	-48	53	60	84	444

- Although both sets of projections assumed an economic slowdown through the end of 2001, neither, obviously, could have accounted for the economic and spending effects of the terrorist attack on America, the ensuing war and homeland security demands, and the budgetary effects of these factors.

- Consequently, it is reasonable to infer that spending in response to the 9-11 attacks, plus unanticipated economic factors, are chiefly responsible for the change in surplus/deficit calculations now being seen.

- As an illustration of the factors affecting the budget surplus, OMB's *Mid-Session Review* shows a comparison of the changes since the February 2001 baseline projection (see page 6 of the *Mid-Session Review*). Those figures show the following:

  - In February 2001, the budget surplus for 2002 was projected to be $283 billion.

  - The projected 2002 surplus was reduced by $41 billion for the tax cut, and another $115 billion for other enacted legislation – most of which was in response to September 11.

  - The President's additional budget proposals reduced the projected surplus by another $15 billion.

  - But in addition, other changes in the economy since February 2001 – including the recession and the effects of the terrorist attacks – reduced the surplus by $278 billion.

  - This combination of factors resulted in an estimated 2002 deficit of $165 billion, according to these figures.

- The administration's accounting is in line with congressional estimates earlier this year. Reports by the House Committee on the Budget and the Congressional Budget Office showed that about one-sixth of the reduction in the 2002 surplus resulted from the tax cut, while five-sixths came from economic changes and spending. (See House Committee on the Budget, *Budget Monitor*, Vol. 2 No. 1, 9 January 2002, and Vol. 2 No. 2, 23 January 2002.)

Revenue Uncertainty

- This year's revenue pattern has presented a kind of paradox in which the economy is growing at a better-than-expected rate, but revenue is declining. This is the result of economic changes whose effects cannot be explained at the time they occur.

- Such tax revenue uncertainty is not unusual when the economy experiences a sudden change, and particularly around "turning points," when the economy is in a recession. Large unexpected "technical" shortfalls for tax receipts also occurred in fiscal years 1990, 1991, and 2001, when the economy also was in recession.

- One thing is certain: the unexplained shortfall this year is not the result of policy changes – policy effects already were accounted for, as noted above. Rather, the unexplained shortfall results from factors beyond the immediate control of policymakers, notably the progressive income tax structure.

  - For example, Internal Revenue Service data show that in 1999, the top 1 percent of all tax filers paid 36 percent of all personal income taxes, and the top 5 percent paid 55 percent of income taxes.

  - The heavy reliance on a small share of taxpayers for the bulk of personal income tax payments – and the volatility of that group's income around economic turning points – produce volatility in tax receipts. Put another way, if the taxable income of these filers declines sharply, Federal revenues may decline to a degree disproportionate with the pattern of overall economic growth.

- The recent negative tax receipt outcomes are a reversal of positive surprises in the late 1990s. The primary sources of the positive surprises were:

  - Higher-than-expected taxable income growth relative to gross domestic product [GDP], including higher dividend income and capital gains.

  - Bracket creep from growth in income beyond the inflation indexation of tax brackets.

  - Faster growth in higher income parts of the income distribution for unidentified reasons (but likely related to the expanding economy and movements in the stock market).

- A reversal of those factors may be the explanation for the current pattern, particularly lower dividend income, lower capital gains realizations, and reduced income growth for higher-income earners relative to others.

- The bottom line: The receipts surprises likely resulted from two general sources: the recession and its unexpected effects on incomes and the income distribution; the declines in the stock market.

SIGNS OF ECONOMIC RECOVERY – HELPED BY THE TAX CUTS

Current Economic Outlook

- Early this year, just after the recession and the shock of the terrorist attacks, nearly all analysts projected a slow economic recovery. Estimates of growth in real GDP (for calendar year 2002) were as follows (see table on the next page):

  - OMB: 0.7 percent.

  - CBO: 0.8 percent.

  - Blue Chip Consensus: 1.0 percent.

- As is now well-known, however, the economy's rebound has been significantly stronger.

  - The economy grew at a 6.1-percent annual rate in the first quarter of 2002.

  - Since then, the economy has settled into a more moderate growth path that the administration estimates at 2.6 percent for this year, and 3.6 percent for 2003 – slightly more modest than Blue Chip, which predicts 2.8 percent for this year and 3.6 percent in 2003. (CBO's projections will be released in August.)

  - The administration's recent economic growth projections are consistent with – or slightly more modest than – those of the House-passed budget resolution (H.Con.Res. 353). (Note: The budget resolution assumptions are the same as the administration's February 2002 assumptions.)

- The administration also projects a steady decline in unemployment over the next several years, consistent with Blue Chip and the House budget resolution. (Employment has been recovering more slowly than the economy itself, partly because of rapid productivity growth. See House Committee on the Budget, *Economic Update*, Volume 1, Number 3, 11 July 2002.)

- Inflation – as measured by the urban consumer price index – is expected to be at or below 2.5 percent per year, according to both the administration and Blue Chip. These figures are again consistent with those of the budget resolution.

Comparison of Economic Assumptions
(Calendar Years)

	2001	2002	2003	2004	2005	2006	2007	Average 2003-07
Real GDP % change, yr/yr								
OMB MSR	1.2	2.6	3.6	3.6	3.4	3.3	3.2	3.4
Blue Chip, July/March	1.2	2.8	3.6	3.4	3.3	3.2	3.1	3.3
OMB Budget (February)	1.0	0.7	3.8	3.7	3.6	3.2	3.1	3.5
GDP price index, % ch yr/yr								
OMB MSR	2.2	1.3	1.9	1.8	1.9	1.9	1.9	1.9
Blue Chip, July/March	2.2	1.3	1.9	2.1	2.2	2.2	2.2	2.1
OMB Budget (February)	2.3	2.0	1.8	1.7	1.8	1.9	1.9	1.8
CPI % ch yr/yr								
OMB MSR	2.8	1.7	2.5	2.4	2.4	2.4	2.4	2.4
Blue Chip, July/March	2.8	1.7	2.5	2.7	2.7	2.8	2.8	2.7
OMB Budget (February)	2.9	1.8	2.2	2.3	2.4	2.4	2.4	2.3
Unemployment rate								
OMB MSR	4.8	5.8	5.6	5.3	5.1	5.0	4.9	5.2
Blue Chip, July/March	4.8	5.8	5.5	5.2	5.0	5.0	4.9	5.1
OMB Budget (February)	4.8	5.9	5.5	5.2	5.0	4.9	4.9	5.1
91-day Treasury Bill								
OMB MSR	3.4	2.0	3.5	4.3	4.3	4.3	4.3	4.1
Blue Chip, July/March	3.4	1.9	3.2	4.3	4.5	4.7	4.7	4.3
OMB Budget (February)	3.4	2.2	3.5	4.0	4.3	4.3	4.3	4.1
10-Year Treasury Note								
OMB MSR	5.0	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Blue Chip, July/March	5.0	5.2	5.7	5.8	5.9	5.9	5.9	5.8
OMB Budget (February)	5.0	5.1	5.1	5.1	5.1	5.2	5.2	5.1

Benefits of the Tax Cuts

- There is widespread agreement that the adoption of the bipartisan tax cuts last year (the Economic Growth and Tax Relief Reconciliation Act [EGTRRA]) provided powerful stimulus for the economy, keeping the recession and unemployment from being more severe and helping to return the economy to expansion.

  - The tax cuts boosted the growth rate of real GDP by about 1 percentage point in the second half of 2001 and by about ½ percentage point during 2002, according to CBO and the Council of Economic Advisors.

  - By the end of 2002, this tax relief will help to boost private payroll employment by 800,000 jobs, according to the Council of Economic Advisors.

  - Putting those estimates another way, they suggest that without the tax cuts, the economy would be growing about ½ percentage point slower, and about 800,000 more people would be on the unemployment rolls.

- CBO and private forecasters have agreed, in published accounts, that last year's tax cuts were well-timed does of fiscal stimulus.

  - Notes CBO: "[I]n contrast to most past recessions, when significant lags accompanied the adoption and implementation of fiscal stimulus, a major source of stimulus this time began in only the fourth month of the recession (July 2001) in the form of tax rebates. (CBO, *The Standardized Budget and Other Adjusted Budget Measures*, April 2002)

  - At the time of its passage, one respected private forecaster (Macroeconomic Advisers of St. Louis) labeled the tax cut package a "Fiscal Policy Bullseye," stating: ". . . once in a while we get lucky, and fiscal policy delivers to the economy a well-timed does of stimulus. This year's tax cut is perhaps the best such example in recent memory."

- Similarly, the economic stimulus legislation from earlier this year – the Job Creation and Worker Assistance Act of 2002 – has short-run budget costs but direct benefits to promote economic growth and jobs.

  - The measure included partial expensing of equipment investment and extended unemployment insurance benefits – provisions targeted at the weak areas in the economy: declining business equipment investment and higher unemployment.

  - Estimates by the Council of Economic Advisors indicate the measure could boost economic growth by up to ½ percentage point, and could create up to 300,000 job, by the end of this year.

- To summarize, the tax reduction and economic stimulus measures enacted last year and this year are boosting real growth and helping to keep the unemployment rate nearly a percentage point lower than without the policies.

SPENDING CONTROL IS CRUCIAL

- The administration's *Mid-Session Review* projects budget deficits for the next 2 years, with a return to surpluses by fiscal year 2005 – if spending is controlled. The administration's spending assumptions include the following:

  - The continuation of only those portions of emergency supplemental measures that require ongoing investments, as opposed to one-time spending. Spending for one-time needs – such as the need to rebuild New York – is assumed to lapse. (As noted above, CBO's projections, expected next month, assume that spending amounts even for one-time events continue indefinitely.)

  - Holding the recent supplemental (H.R. 4775), now in conference, to the $27.1-billion level in the President's request.

- Maintaining all needed spending for the war against terrorism and enhancing homeland security.

- Holding all other non-war, non-homeland-defense spending to annual growth of 2 percent.

- The Mid-Session Review notes that discretionary spending has grown by 7.4 percent per year since 1998, and projects that continuing that rate would add $2 trillion to the Government's debt by 2012 (see chart below).

- The administration's projections also account for other key priorities, and the overall plan is consistent with total amounts provided in the House budget resolution.